

Investment Banking Briefing

Step change in the use of schemes of arrangement in takeovers

The last 12 months has seen a major shift in attitude in favour of using schemes to effect takeovers.

Most of the highest profile deals of the past year - Morrisons/Safeway, the CVC sponsored bid for Debenhams, the Hicks Muse sponsored bid for Weetabix and the Morgan Stanley sponsored bid for Canary Wharf - have utilised schemes, challenging many of the orthodox perceptions.

This briefing looks at the reasons for this change, analyses recent developments on schemes - for example, the use of irrevocables - and comments upon points of interest which have arisen on recent takeover schemes. The table overleaf summarises some recent takeovers which have been effected or proposed by way of a scheme.

Introduction

A scheme of arrangement is a procedure provided by section 425 of the Companies Act 1985 whereby, in a takeover context, a target company's shares are cancelled and then reissued (or simply transferred) to the bidder, in return for which the bidder pays the consideration to the target's shareholders. Technically, a scheme is

an arrangement between the target company and its shareholders, in contrast to an offer, which is a proposal made by the bidder direct to the target's shareholders. It is therefore a procedure which, in principle at least, is much more in the hands of the target.

The traditional view

Perhaps the main reason that schemes of arrangement have not been more widely used in takeovers has been a lack of familiarity with them. Underlying that lack of familiarity have been some negative perceptions:

- they are more favourable to targets than to bidders because the target controls the process (in a merger of equals this can be a positive factor);
- they are not flexible and are to be avoided if there is a risk of a competing bidder;
- they tend to be used by weak bidders who are attracted by needing only 75 per cent of votes (as opposed to 90 per cent of acceptances) for full control;
- the extra documentation cost of a scheme can outweigh the stamp duty saving; and
- irrevocable undertakings cannot be used on schemes.

Historically, therefore, schemes of arrangement have tended to be used

only in highly leveraged deals (because of the lending banks' requirement that they have certainty that target security will be granted and less concern about control of the process) or the very largest deals, where the stamp duty saving is significant.

Recent changes

There have been recent changes in market practice, culminating in the use of schemes in the bids for Safeway, Debenhams and Canary Wharf, which may cause a shift in perception. Schemes can now be shown to bring advantages of certainty, speed and security for both the bidder and its lenders. These benefits may reduce bank costs in leveraged offers and in turn give schemes a cost advantage more often than has been realised. As the advantages become more apparent, one disadvantage - the perception of weakness - decreases.

Speed. The indicative timetables overleaf comparing a scheme to a takeover offer demonstrate that, although it may take comparatively little time to achieve 50 per cent acceptances under a takeover offer, attaining 100 per cent control is almost always quicker under a scheme.

Certainty. A scheme also provides certainty in that it delivers 100 per

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cent control instantly upon its becoming effective. In most offers, by contrast, the offer has to be declared unconditional before there is certainty that 100 per cent control will ever be achieved, and in all cases before it is actually achieved. Recent high-profile examples where the compulsory acquisition threshold has not been reached (such as the bid for Pizza Express) have served to highlight the issue for bidders. In addition, it appears that there may be a new willingness among institutional shareholders either to buy shares to prevent themselves being squeezed out or simply to be prepared not to accept offers and to remain as minority shareholders. This attitude has, to some extent, been encouraged by a high degree of cynicism amongst outside shareholders in the case of certain public to privates, where there has been a suspicion that insiders are getting low price deals.

Security. As well as the advantage of certainty, there are other reduced risks for lenders on a scheme - as opposed to an offer. For good practical reasons, security over target assets cannot generally be granted until 100 per cent ownership is obtained. On a scheme route, this can usually happen more quickly (a reduction of risk in itself) as a result of avoiding the six-week delay of the squeeze-out process on an offer. Indeed, under a scheme, although the steps and paperwork involved may be intricate, it may be possible for target security to be put in place between the scheme becoming effective and the funds being drawn down to pay target shareholders. As a scheme

delivers 100 per cent control and guarantees that target security will be granted, it also avoids the potential tension which can arise on leveraged takeover offers between the bidder's wish to go unconditional so as to obtain control as quickly as possible and the lending banks' desire for the bidder to delay going unconditional until 90 per cent acceptances have been reached (at which point the lending banks will know that target security will be capable of being granted once the squeeze-out process has been completed).

Costs. The extra complexity of a scheme typically adds to documentation costs, but on almost all schemes stamp duty (at 0.5 per cent of the target's value at the offer price) can be saved. In addition, the reduction in the lending banks' risks may benefit the choice of a scheme if there is a step down in the debt cost once security is granted.

Control of the process. A scheme is the target company's scheme. The target presents the deal to its shareholders and to the court and has to file the necessary papers, etc. The element of control this has given targets has historically discouraged bidders from using schemes. The pattern is, however, changing. Bidders are using the pressure of a potential offer to extract from targets a degree of legally binding commitment to pursue the process quickly, in the form of a "merger agreement" or "implementation agreement". There is no settled market practice - at least as yet - that targets will agree to any

obligations, let alone how strict those would be, but there is a clear trend towards having such agreements.

With or without a merger agreement, the negotiating power of a bidder with a recommendable offer has increased: at a legal level, directors of targets are more cautious about their duties; at a political level, they are more wary of shareholder power.

Extra points of interest

The recent rise in the use of schemes, notably in the bid for Debenhams, has highlighted some additional interesting features including:

- the use of irrevocables;
- the certain funds period;
- the position of target shareholders;
- the risk of ginger groups;
- inflexibility in contested situations;
- the application of US registration requirements; and
- the application of the Takeover Code.

Irrevocables. An issue of particular relevance in the case of takeovers by way of scheme is whether a target shareholder who has given an irrevocable undertaking to vote in favour of a scheme will constitute a separate class of shareholder, therefore requiring the scheme to be approved separately by shareholders who have not provided irrevocable undertakings. Traditionally the advice was always given that irrevocables were "dangerous" in this context and they were therefore not used. However, in recent schemes, there seems to have been a softening of approach towards the use of irrevocables. Although hard irrevocables may continue to give cause for concern, they have been successfully used in recent schemes (but not challenged), as have soft irrevocables with a considerable premium (e.g. Weetabix 25 per cent and New Look 10 per cent).

Recent schemes to effect takeovers

Bidder	Target	Approximate Value (£ billion)
Wm. Morrison Supermarkets PLC	Safeway plc	3.0
Baroness Retail Limited	Debenhams plc	1.72
Silvestor UK Properties Limited	Canary Wharf Group plc	1.55
Smith & Nephew plc	Centerpulse AG	1.5
Hicks, Muse, Tate & Furst Inc.	Weetabix Limited	0.642

Certain funds. The certain funds period can be shorter under a scheme. On a typical offer, it is not unusual for the certain funds period to extend to six or seven months. In the case of a scheme, the single date for payment to target shareholders means that the certain funds period would usually need to be no longer than about four or five months.

Forcing shareholders to act. In an offer, target shareholders may feel they have the luxury of waiting to see what other shareholders do or even what might emerge in the market. Under a scheme, however, they typically have only 21 clear days (the period between the posting of the documents and the date of the shareholders' meeting) in which to decide how to vote. They have some protection in that the court is unlikely to give its blessing to a scheme which contains a lower offer than one which has emerged after the meeting, but so far as the shareholders' own powers are concerned, any votes not cast at the meeting after 21 clear days are lost, although shareholders would be able to petition the court. This puts pressure on them to make their minds

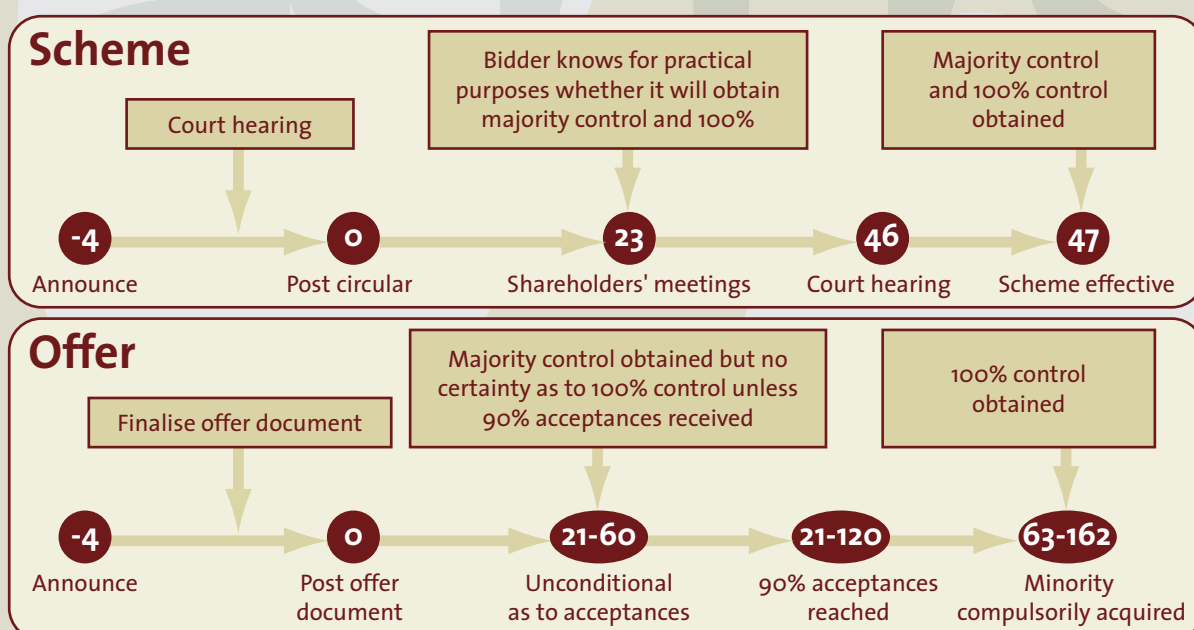
up. Even where, at the insistence of the target, the shareholders' meeting is held later than "day 23" in order to afford other interested parties time to decide whether to proceed with an offer, the shareholders' meeting is still likely to be held considerably in advance of "day 60" (the Panel treats the shareholders' meeting as the equivalent to "day 60" under a takeover offer - see Application of Takeover Code below).

Ginger groups. There is, however, an extra concern for bidders using a scheme: in addition to achieving the approval of 75 per cent of votes cast at the meeting, they also need the approval of a majority in number of shareholders voting. As a result, a relatively small group of disgruntled shareholders can tilt the balance. This may necessitate paying greater attention to softer issues that matter for example to employee shareholders, such as management continuity, redundancy plans and the treatment of optionholders. There is also potentially scope for a competing bidder to try to influence the outcome of the shareholders' meeting by entering into stock borrowing

arrangements (such as those entered into by Laxey when it attempted to put pressure on British Land at its AGM) or by holding shares in multiple names. The Panel is unlikely to approve of such techniques.

Inflexibility. Historically, schemes have been regarded as inflexible in competitive situations because of the need to revert to court to amend the terms of the scheme and the need to convene a further meeting of the target's shareholders if the initial meeting of target shareholders has already taken place by the time the increased offer is announced. The issues have not been tested to destruction, but the use of schemes in the bids for Hilldown, First Technology, Debenhams and Canary Wharf suggest that this point now holds less concern for bidders. In general terms, the requirement to revert to the court to amend the scheme will not give rise to any difficulties, and the requirement to revert to shareholders (even if on 21 clear days' notice - although 7 to 14 days' notice may suffice) does not give rise to any substantial delay in the

Timetable to obtain control - uncontested situation



timetable when compared to a takeover offer.

In fact, a scheme can offer additional flexibility where regulatory clearances are required. For example, in *National Grid/Lattice (2002)* the shareholders' meeting was held but as clearances were not expected for approximately three months the court hearing was delayed until such time as the clearances were obtained. This was also sanctioned by the Panel.

US securities registration. Schemes have an interesting advantage over offers where shares are being offered as consideration and the target has a substantial US shareholder base. If shares are to be offered to US holders in the context of an offer, there may be a need to go through the SEC registration process - which is demanding and expensive, especially for inexperienced companies. Where a scheme route is used, however, there is an exemption available from the full registration requirement.

Application of Takeover Code.

Schemes are subject to the Code, but the Panel has had to adapt its normal timetable requirements in order to accommodate the different way in which schemes operate. The Panel treats the date of the target shareholders' meeting as the last date for the offer to go unconditional as to acceptances ("day 60") and the date of the final court hearing as the offer going wholly unconditional ("day 81"). "Day 46" and "day 39" are determined by working back 14 and 21 days respectively from "day 60" and will, as normal, be adjusted by reference to a second competing offeror's timetable. This approach can lead to some awkward issues where a scheme comes into competition with an offer. In Panel Statement 2004/1 (Canary

Wharf), the Panel had to decide, pursuant to Note 1 on Rule 19.3, when to require clarification from the parties who had made announcements of the possibility of making offers. Normally in an offer, this would, following the ruling made during the competing bids for National Westminster Bank, be around "day 50" of the first offeror's timetable (i.e. approximately ten days before the last date for the offer to go unconditional as to acceptances). In a scheme, that date is much earlier in the process because "day 60" is deemed to be the date of the target shareholders' meeting. Since the meeting can be held on "day 23" (see timetable), this would have the curious result of requiring other parties to clarify their intentions by "day 13" of the first bidder's timetable, not giving the other parties very much time to prepare and consider their options. In the Canary Wharf case, the notice period for the shareholders' meeting was longer than usual (37 clear days) thereby giving the other parties more time before they reached the deemed "day 50" deadline. However, one can imagine a situation which would be more awkward, where the scheme documents were posted on a normal meeting timetable (21 clear days) and then a second party tried to intervene; in practice, if it appeared to be a serious alternative, the target board would be likely to adjourn the shareholders' meeting to allow the second bidder time to formulate its proposals.

This also highlights one of the main potential problems with a scheme. Once an offer has gone unconditional as to acceptances, it will be very difficult for a counter-offer to succeed (withdrawal rights fall away at this point). Once shareholders have voted on a scheme, however, the scheme is

to a great extent in the hands of the target board until it is approved by the court and becomes effective. If a counter-offer is announced in this period, the target directors could decide to discontinue the original scheme despite the prior shareholder vote to approve the scheme.

The future

Recent deals have shown that the advantages which schemes can have over offers are greater than previously thought. As a result, we expect a rise in the use of schemes, particularly for leveraged transactions and public to privates.

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